

This record is a partial extract of the original cable. The full text of the original cable is not available.

251301Z May 06

C O N F I D E N T I A L SECTION 01 OF 02 ANKARA 003005

SIPDIS

TREASURY FOR INTERNATIONAL AFFAIRS - CPLANTIER AND MNUGENT

E.O. 12958: DECL: 03/22/2011

TAGS: [EFIN](#) [PGOV](#) [TU](#)

SUBJECT: TURKEY: POLITICS REINFORCES MARKET TENSION

REF: ANKARA 2901

Classified By: DCM Nancy McEldowney for reasons 1.4(b) and (d).

This is a joint Embassy Ankara-Congen Istanbul cable.

1. (SBU) Summary: Turkish markets have sold off sharply over the past two weeks in line with most global financial markets. Turkey has been among the harder hit emerging markets because of its current account deficit, but also because the global sell-off coincided with rising domestic political tensions and uncertainty. The business community fears the political tension risks eroding Turkey's recent stability and stalling the country's return to prosperity, as well as potentially endangering the EU accession process. Following the May 17 assassination of a senior Turkish judge, the outlook is for more mutually reinforcing political and market tension. End Summary.

Global Sell-off Hits Turkey Hard

2. (SBU) Turkish financial markets, like most financial markets worldwide, suffered a sharp sell-off over the past two weeks. The Istanbul stock exchange fell by about 18% in two weeks and 23% from its February peak, while the lira dropped 15% against the dollar to 1.54 (YTL per dollar) and 20% against the euro, while the yield on the benchmark bond hit 16.18%, up from 13.85% at the beginning of the year.

Bubble Warnings Unheeded

3. (SBU) In recent months, market analysts increasingly warned of a risk of a correction, with many of our financial contacts telling us only good news was "priced in," setting the stage for a downward correction. Compared to other emerging markets, many analysts point to Turkey's large and growing current account deficit, much of which is financed by short-term portfolio investment, as a particular vulnerability. Driven by booming financial inflows, there were clear signs of bubble-like behavior in everything from real estate prices to stocks and government bonds. Credit Suisse Economist Berna Beyazitoglu's comment to us -- that she had run out of different ways to tell investors the Turkish markets were overpriced -- was representative of the warning notes sounded by market analysts.

Domestic Politics Deepen Drop

4. (C) The sell-off coincided with a dramatic increase in domestic political tensions between PM Erdogan's pro-Islam Justice and Development Party (AKP) Government and the secularist establishment, including the military (reftel). Views are mixed, however, on how big a role domestic political uncertainty played in the sell-off. While Economy Minister Babacan blamed the market drop entirely on global factors, few independent observers agreed. In a May 24 meeting with the Ambassador, new Central Bank Governor Durmus Yilmaz agreed with what is also the market consensus that the main driver was the drying up of global liquidity, but that the sell-off would not have been as severe without local factors. Markets' and the business community's main concerns are over how political instability could affect the AKP Government's ability to continue the market- and EU-friendly economic reforms opposed by the statist political-judicial-military establishment. President Sezer's recent veto of Social Security reform legislation and the virulent opposition to recent privatizations heightened this concern.

Business Playing for Time

5. (C) Still, business observers have not given up hope. Many note that statist-Islamist tensions are of long standing and should not mask the fundamental improvements in Turkey's

macroeconomic situation. After the turbulent 1990's and the harsh 2001 crisis, business has reveled in three plus years of political stability under a one-party government, orthodox economic policies, and a steady return of prosperity and profitability. Increased political tensions raise the possibility of early elections that could bring a market-unfriendly party such as the nationalist MHP into a weak coalition government and even the possibility of some sort of confrontation with military. Perhaps most negatively for business people, rising political tensions could derail Turkey's EU accession process, which business contacts see as a powerful modernizing and stabilizing force.

16. (C) Big Turkish corporations, like the giant Koc group, are also heavily exposed to the exchange rate fall, having borrowed in foreign exchange to finance their recent growth without taking advantage of hedging tools. Big business leaders -- telling us privately they don't want to roil the waters -- have been relatively quiet in their public statements since the May 17 shooting. Leading executives seem hesitant to say anything that might contribute to a perception of panic or crisis and reluctant to speculate about what they characterize as an "extremely serious, but opaque" political situation.

Fasten Your Seatbelts

17. (C) With no domestic political fix apparent, global markets entering a new stage less friendly to countries like Turkey, and a large potential for a crisis in the EU accession process, there appears to be little relief in store over the short term as political and market tensions reinforce each other in what could be a downward spiral. However, economic policy fundamentals remain sound and the reforms Turkey has made since 2001, including the floating exchange rate, better banking oversight, fiscal reforms and debt reduction, will reduce the potential for financial volatility to spill over into the real economy. If Turkish leaders are able to prevail against their populist instincts and maintain strong fiscal and monetary policies, there is a chance the damage of recent weeks can be contained. This, however, will not come easily; U.S. and European leaders can play a supportive role with messages that encourage Turkish leaders to remain calm and balanced during a turbulent period.

Visit Ankara's Classified Web Site at
<http://www.state.sgov.gov/p/eur/ankara/>

WILSON